

**IN THE
SUPREME COURT OF MISSOURI**

No. 83888

**MEDICINE SHOPPE INTERNATIONAL, INC.,
Appellant,**

v.

**DIRECTOR OF REVENUE,
Respondent.**

**On Petition for Review from the
Missouri Administrative Hearing Commission
Honorable Willard C. Reine, Commissioner**

BRIEF OF APPELLANT

SHUGHART THOMSON & KILROY, P.C.

**William Prugh#21205
Richard Lenza #38527
Twelve Wyandotte Plaza
120 W. 12th Street
Kansas City, MO 64105
(816) 421-3355
(816) 374-0509 (Fax)**

Attorneys for Appellant

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JURISDICTIONAL STATEMENT

This appeal involves the construction of Section 143.451 of the Revised Statutes of Missouri,¹ which is a revenue law of the State of Missouri. This Court has jurisdiction under Article V, Section 3 of the Missouri Constitution.

¹ All statutory citations are to the Revised Statutes of Missouri of 2000.

STATEMENT OF FACTS

During the periods at issue, Medicine Shoppe's primary business was franchising retail pharmacies located throughout the United States. Its income was primarily from (1) origination fees paid by franchisees (also identified as ~~A~~licensees~~@~~) when the franchises were started; AHC Tr. 10 (2) fees from franchisees based on a percentage of the franchisees' sales; AHC Tr. 10 and (3) receipts from the sale of tangible property (pharmaceutical supplies) to the franchisees. In addition, during the periods at issue, Medicine Shoppe also received income from the following: loan origination fees and interest on loans to franchisees to finance opening costs, equipment purchases and service charges (interest) on accounts receivable (from the sale of pharmaceutical supplies) not paid within the prescribed time period; service charges (interest) on the late payment of license fees; and income from state and local government obligations. AHC Tr. 20. However, Medicine Shoppe's financing is not mandatory and is purely voluntary on the part of the franchisee. AHC Tr. 13.

Medicine Shoppe on its returns and/or amended returns calculated its taxable income by using the single factor apportionment method of Section 143.451, R.S.Mo. Medicine Shoppe classified and reported its loan origination fees and interest income, service charges on accounts receivable and interest income from service charges on the late payment of license fees as non-Missouri source income. AHC Joint Exhibit A through W.

POINT RELIED ON

The administrative hearing commission erred in denying appellant=s claims for refund because based on Sections 621.189 and 621.193 that decision is not authorized by law or supported by competent and substantial evidence in that appellant's income derived from loans to non-Missouri franchisees who used the loan funds entirely outside the State of Missouri and therefore is not Missouri source income under Section 143.457 R.S.Mo.

§ 143.451

Petition of Union Electric Company of Missouri, 161 S.W.2d 968 (Mo. 1942)

Union Electric Company v. Coale, 146 S.W.2d 631 (Mo. 1940)

Goldberg v. State Tax Commission, 639 S.W.2d 796

ARGUMENT

- I. The Administrative Hearing Commission Erred In Denying Medicine Shoppe's Claims For Refund Because Based On Sections 621.189 and 621.193 That Decision Is Not Authorized By Law Or Supported By Competent And Substantial Evidence In That Medicine Shoppe's Income Derived From Loans To Non-Missouri Franchisees Who Used The Loan Funds Entirely Outside The State Of Missouri And Therefore Is Not Missouri Source Income Under Section 143.457.**

Standard Of Review

Final decisions of the administrative hearing commission are subject to review by this Court pursuant to Section 621.189.

The standard of review set forth in Section 621.189 states that a decision of the Administrative Hearing Commission shall be upheld only if (1) authorized by law; (2) supported by competent and substantial evidence upon the whole record; (3) if a mandatory procedural safeguard has not been violated; and (4) the exercise of authority, by the Administrative Hearing Commission, does not create a result or results clearly contrary to the reasonable expectations of the general assembly at the time such authority was delegated to the agency. Standards 1 and 2 above are the only standards at issue in this case.

In addition, this Court reviews the Administrative Hearing Commission's interpretation of revenue laws *de novo*. *L & R Egg Co. v. Director of Revenue*, 796 S.W. 2d 624, 625 (Mo. banc 1990), *Zip Mail Services, Inc. v. Director of Revenue*, 16 S.W.3d 588, 590 (Mo. banc 2000).

Finally, the taxing statutes are to be strictly construed against the Director in favor of the taxpayer. *Petition of Union Electric Company of Missouri*, 161 S.W.2d 968 (Mo. 1942).

A. Missouri Provides for Two Methods of Apportionment

Missouri provides two alternative methods for apportionment of Missouri taxable income, the statutory single factor apportionment method of Section 143.451, R.S.Mo., and the three factor apportionment method prescribed under the Multistate Tax Compact (MTC) as set out in Section 32.200, R.S.Mo.

It is well established that the single factor apportionment method is to be applied only to income derived from sources within the State of Missouri. Medicine Shoppes interest and origination fees are from capital used outside the state of Missouri and therefore are non-Missouri source income. This source of income test has been continually affirmed by this Court, *Goldberg v. State Tax Commission*, 639 S.W. 2d 796 (Mo. 1982), *Dow Chemical Company v. Director of Revenue*, 787 S.W. 2d 276 (Mo. banc 1990).

The taxpayer can elect to apportion income derived from the transactions upon the source of income method stated in Section 143.451, R.S.Mo. or under the guidelines of the Multistate Tax Compact (AMTC). The adoption of the Compact was not intended to foreclose the "source of income" test for determining whether a taxpayer is entitled to apportion its income, *Goldberg v. State Tax Commission*, 639 SW2d 796 (Mo. 1982). In *Dow Chemical Company v. Director of Revenue*, 787 S.W.2d 276, 284 (Mo. banc 1990), this Court discussed the differences between the two apportionment methods. There, this Court concluded that the source of income test and its single factor method of apportionment were a complete and integrated system of apportionment, separate and apart from the Multistate Tax Compact (ACompact) designation of business and nonbusiness income and its three-factor apportionment formula. *Id.*; see also *Goldberg v. State Tax Commission*, 639 S.W.2d 796 (Mo. banc 1982).

B. Unitary Business Principles Are Not Applicable to Single Factor Apportionment

A crucial distinction between the two alternative methods exists due to the application of unitary concepts of taxation under the three factor MTC formula averaging property, payroll and sales ratios to derive its Missouri taxable income. *See Philip Morris, Inc. v. Director of Revenue*, 760 S.W.2d 888, 889 (Mo. banc 1988); *Luhr Bros., Inc. v. Director of Revenue*, 780 S.W.2d 55, 57 (Mo. banc 1989). The MTC three factor formula apportions income on the premise that a multistate corporation operates as a unitary business. Under the single factor apportionment method, unitary concepts are irrelevant, and the focus is upon what Missouri has characterized as Asource of income@taxation. *Dow Chemical Company, Inc. v. Director of Revenue*, 834 S.W. 2d 742 (en banc, 1992). Medicine Shoppe=s appeal primarily involves the construction of Section 143.451. Section 143.451 is a taxing statute. Therefore, Section 136.300 mandates that Awith respect to any issue relevant to ascertaining the tax liability of a taxpayer all laws of the state imposing a tax shall be strictly construed against the taxing authority in favor of the taxpayer. *Petition of Union Electric Company of Missouri*, 161 S.W.2d 968 (Mo. 1942).

The Compact=s apportionment of income is predicated on the income of the unitary business and therefore apportions income from all sources. *Dow Chemical*, 787 S.W.2d at 284. As stated above the source of income formula taxes income that is only from transactions wholly or in part in Missouri. *Maxland Development Corporation v. Director of Revenue*, 960 S.W.2d 503 (Mo. banc 1998). The Source of Income has been defined as the place where the income was produced *In Re Kansas City Star Company*, 142 S.W. 2d 1029 (en banc 1940). Under the source of income concept, it is well established that income sourced outside Missouri is excludable from income subject to Missouri taxation. *Dow Chemical Company, Inc. v. Director of Revenue*, 1989 WL 103255 (En Banc 1989).

In *Petition of Union Electric Company of Missouri*, 161 S.W.2d 968 (Mo. 1942) and *Union Electric Company v. Coale*, 146 S.W.2d 631 (Mo. 1940), this Court concluded that income derived from a loan of money used by a non-Missouri entity wholly outside of Missouri is not Missouri source income under Section 143.451. This Court concluded that dividend income from shares of stock in corporations operating wholly outside of Missouri and interest income from a bond of a corporation operating entirely outside of Missouri did not constitute Missouri source income. This Court determined that there are three sources from which income can derive: labor; capital; and profits derived from the sale or exchange of capital assets. *Id.* at 970. The court stated that the locus of the source of income is determined as follows: In the case of income derived from labor, it is the place where the labor is performed; in the case of income derived from use of capital; ***it is the place where the capital is employed***; and in the case of profits from the sale or exchange of capital assets, it is the place where the sale occurs.² *Id.*, citing *In re Kansas City Star Company*, 142 S.W.2d 1029 (Mo. 1939).

With respect to the dividend income, this Court noted that the actual use of the capital that gave rise to the income represented by these dividends took place outside Missouri

In *Union Electric* this court concluded that "[the source of income is the place where it was produced[.]" *Id.* at 635. In *Petition of Union Elec. Co. of Missouri*, 161 S.W.2d 968, 970 (Mo. banc 1942), the court reexamined the facts presented in the previous Union Electric case (*Union Electric Co. v. Coale*, 146 S.W.2d 631 (Mo. 1940)) and reached the same conclusion, stating that the locus of the source of income is determined as follows: In the case of income derived from labor, it is the place where the labor is performed; in the case of income derived from use of capital, it is the place where the capital is employed; and in the case of profits from the sale or exchange of capital assets, it is the place

² Emphasis added here and throughout, unless otherwise noted.

where the sale occurs. The court further stated that: "the mere point where payment reaches the hands of the taxpayer is not determinative of the source of the income . . . the source of the income is the person paying the interest and not the mere bond itself, which is only an evidence of the indebtedness." *Id.* at 972. Therefore, the court concluded that the interest payments were not from a Missouri source. *Id.* We agree that the application of the source of income test leads to the conclusion that the income in question is from sources outside Missouri under section 143.451.1. *Id.* Therefore, Petitioners may allocate this income as non-Missouri source income that is not subject to apportionment. *Brown Group, Inc. v. Administrative Hearing Commission*, 649 S.W.2d at 880 (Mo. 1983).

C. Loan Origination Fees and Interest Income of Medicine Shoppe Is Not Missouri Source Income

In *Goldberg v. State Tax Commission*, 639 S.W.2d 796 (Mo. 1982), this Court affirmed the source of income test. Clearly the legislature and the Court has recognized that Missouri headquartered companies can and do have non-Missouri source income. The company in *Goldberg* was a Missouri corporate manufacturer, located in Missouri, not domesticated in any other state, it neither owned property nor maintained branch offices outside Missouri, elected the single factor method and it paid no income tax to any state other than Missouri. The issue in *Goldberg* was whether the company, for purposes of determining its Missouri income tax liability, apportion the income it derived from the sale of goods to out-of-state customers. The Missouri legislature has never repealed the source of income test in Section 143.451.1. The legislature has had many opportunities to amend the income tax statutes. The legislature

could have easily have amended the statutory language to eliminate the source of income test when it enacted the Missouri Multi State Tax Compact. This Court in *Goldberg* stated that at the time Missouri adopted the Compact in 1967 the source of income test embodied in present ' 143.451 was effective and therefore was recognized as controlling under Article III, ' 1 of the Compact and the legislature could have provided in adopting the Compact to eliminate the source of income test. However, the Goldberg Court stated that "It is clear, therefore, that the legislature did not intend by the adoption of the Compact to vitiate the source of income test of ' 143.451."

In this matter the Medicine Shoppe derived loan origination income and interest income by providing its capital to its out-of-state franchisees for use wholly outside Missouri. Medicine Shoppe elected to use the single factor method of apportionment under Section 143.451. Therefore, Medicine Shoppe's loan origination income and interest income should not be treated as Missouri source income.

This Court in *Petition of Union Electric Co. of Missouri*, 161 S.W.2d 968 (en banc 1942) dealt with the issue of bonds issued by the Union Electric Company of Illinois but held by the taxpayer in Missouri. The taxpayer excluded these items from taxable income. The payors of the interest and dividends were located in Illinois, the obligation was not secured by any liens on Missouri property and the capital was utilized in Illinois. This Court held that the entire amount of interest income was non-Missouri source income properly excluded by taxpayer from its Missouri income subject to apportionment. In addition the Court found that the actual expenditure of labor and the use of capital which gave rise to the income took place outside the state of Missouri. The issue presented was whether or not the dividends and interest payments are income received by the taxpayer from sources within this state. As stated previously, this Court held that the locus of the source of income is determined as follows: In this case of income derived from labor, it is the place where the labor is performed; in the case of income derived from use of

capital, it is the place where the capital is employed; and in the case of profits from the sale or exchange of capital assets, it is the place where the sale occurs.

This Court has consistently followed its holding in *Petition of Union Electric* that income earned from the use of capital outside of Missouri is not Missouri source income, and therefore not subject to apportionment under the single factor method of Section 143.451. *See, e.g., Union Electric Company v. Coale*, 146 S.W.2d 631 (Mo. 1940) (dividend income received from companies operating exclusively outside Missouri was not Missouri source income); *A.P. Green Fire Brick Company v. State Tax Commission*, 277 S.W.2d 544 (Mo. 1955) (royalty income paid by foreign corporation for use of Missouri corporation's trademarks, trade names and manufacturing processes is not Missouri source income and not subject to single factor apportionment because income was derived from activities outside Missouri); *Brown Group, Inc. v. Administrative Hearing Commission*, 649 S.W.2d 874 (Mo. banc 1983) (royalty income earned by Missouri corporation for use of Missouri corporation's trade names, shoe designs and shoe patterns is not Missouri source income and not subject to single factor apportionment because income was derived from activities outside Missouri).

In this case, Medicine Shoppe loaned money to its out-of-state franchisees for use exclusively outside of Missouri. The out-of-state franchisees used Medicine Shoppe's capital exclusively outside of Missouri. Medicine Shoppe's loan origination income and interest income was derived solely through the use of this capital outside of Missouri. Therefore, under this Court's long-standing interpretations of the source of income rules, Medicine Shoppe's loan origination and interest income is not Missouri source income subject to tax under Section 143.451.

The Director cited several of this Court's decisions in an attempt to distinguish Medicine Shoppe's income from the rules set forth by this Court in *Petition of Union Electric Company*, *Union Electric*

Company v. Coale and *A.P. Green*. However, because none of these cases contradict this Court's holdings in those cases, the Director's attempts to use these cases to depart from this Court's long-standing interpretation of the source of income rules should be rejected.

D. The Commission's Treatment of the Loan Origination Income and Interest Income as Missouri Source Income Is Inconsistent With the Case Law and Section 143.451

The Administrative Hearing Commission (Commission) and the Director relied on *J.C. Nichols Company v. Director of Revenue*, 796 S.W.2d 16 (Mo. banc 1990). In the *Nichols* case the taxpayer developed, managed and sold real estate in Kansas and Missouri. The circumstances in *Nichols* were clearly distinguishable from the present cases in that the income was derived through the use of *labor* (i.e., the active management and decision-making surrounding the real estate). The *Nichols* case did not in any way change this court's decision in *Petition of Union Electric Co. of Missouri*, 161 S.W.2d 968 (en banc 1942) which stated that the locus of the source of income is determined as follows: In the case of income derived from labor, it is the place where the labor is performed; in the case of income derived from use of capital, it is the place where the capital is employed; and in the case of profits from the sale or exchange of capital assets, it is the place where the sale occurs.

Contrary to the Director's opinion the Medicine Shoppe's position is in fact consistent with *Nichols*. The loan origination income and interest income was derived through the use of Medicine Shoppe's capital by out-of-state franchisees.

Based on *Petition of Union Electric Company of Missouri*, 161 S.W.2d 968 (Mo. 1942), the interest income is not derived from sources within Missouri and therefore we never reach the apportionment formula stated in Section 143.451.2. Therefore, Petitioner correctly excluded from income,

as non-Missouri source income, loan origination fees and interest income from non-Missouri franchisees pursuant to Section 143.451.1 R.S.Mo

Neither the Director nor the Commission explained how any of these facts distinguished Medicine Shoppe's situation from the basic facts set forth in *Petition of Union Electric Company of Missouri*, 161 S.W.2d at 971 (Mo. 1942).

E. The Commission Erred in Including the Origination Income and Interest Income Since the Funds Were an Investment and Reinvestment of Medicine Shoppe's Own Funds

The Commission also erred in including the loan origination fees and interest received on loans to out-of-state franchisees as classified as partly within and partly without Missouri under section 143.451.

The formula under Section 143.451.2 includes three factors; (1) transactions wholly in this state; (2) transactions partly within this state and partly without this state; and (3) transactions wholly in this state or not partly within this state and partly without this state. However, Section 143.451.2(2)(b) states that "The investment or reinvestment of its own funds, or sale of any such investment or reinvestment, shall not be considered as sales or other business transacted for the determination of said fraction.

The funds Medicine Shoppe used for the loans to out of state franchisees is a reinvestment of its own funds. Donald Schrieber, Vice President of Finance, Chief Financial Officer of Medicine Shoppe testified, in regard to a question involving the purpose of the financing:

It is an accommodation to some degree of helping the franchisee get opened sooner, but frankly we have excess funds, and we lend this out or we invest it in municipal bonds or other securities, but this was just another source of the excess funds that we receive from franchise fees. AHC Tr. 20.

Therefore, the Origination Fees and Interest Income should also be excluded under Section 143.451.2(2)(b).

Based on *Petition of Union Electric Company of Missouri*, 161 S.W.2d 968 (en banc), *Union Electric* case and other cases cited the interest income is not derived from sources within Missouri and therefore we never reach the apportionment formula stated in Section 143.451. Therefore, Petitioner correctly excluded from income, as non-Missouri source income, loan origination fees and interest income from non-Missouri franchisees pursuant to Section 143.451.1. Respondent's disallowance of loan origination fees and interest income, from non-Missouri franchisees, as non-Missouri source income is contrary to Section 143.451.1 and is contrary to this Court's decision in *Petition of Union Electric Co. of Missouri*, 161 S.W. 2d 968 (en banc 1942), *A.P. Green Fire & Brick Company v. Missouri State Tax Commission*, 277 S.W. 2d 544 (en banc 1955); *Union Electric v. Coale* 146 S.W. 2d 631 (en banc 1940).

CONCLUSION

This Court should reverse the decision of the Commission and determine that Medicine Shoppe's loan origination income and interest income does not constitute Missouri source income under the single factor method of apportionment.

Respectfully submitted,

SHUGHART THOMSON & KILROY, P.C.

William Prugh#21205

Richard Lenza #38527

Twelve Wyandotte Plaza

120 W. 12th Street

Kansas City, MO 64105

(816) 421-3355

(816) 374-0509 (Fax)

Attorneys for Appellant

CERTIFICATE OF SERVICE

I hereby certify that two true and accurate copies of the foregoing along with disk with copy of the brief, were sent via Federal Express, this 26th day of October, 2001, to:

Alana Barragan-Scott
Deputy State Solicitor
Broadway State Office Building
221 West High Street
6th Floor
P. O. Box 899
Jefferson City, MO 65102

RICHARD E. LENZA

CERTIFICATE REQUIRED BY SPECIAL RULE 1(C)

I hereby certify that the foregoing brief includes the information required by Supreme Court Rule 55.03 and complies with the limitations contained in Supreme Court Special Rule 1(b). The foregoing brief contains 5,259 words.

The undersigned further certifies that the disk simultaneously filed with the briefs filed with this Court under Supreme Court Rule 84.05(a) has been scanned for viruses and is virus-free.

RICHARD E. LENZA